

INSIGHTS

Shareholders Seeking Books and Records Must Demonstrate Credible Basis to Infer Wrongdoing

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On February 2, 2017, the Delaware Court of Chancery reaffirmed that shareholders seeking to inspect the books and records of Delaware corporations must demonstrate a credible basis to infer corporate wrongdoing. Accusations based on mere "suspicion and curiosity" will not suffice. Applying this standard, Vice Chancellor Joseph R. Slight III denied a shareholder's books and records demand to electric car-maker Tesla Motors, Inc. ("Tesla"), finding that the shareholder failed to articulate a credible basis for his theory that Tesla had fabricated production and delivery problems to conceal flagging demand for its vehicles. *Haque v. Tesla Motors, Inc.*, C.A. No. 12651-VCS (Del. Ch. Feb. 2, 2017).

Case Background

On June 15, 2015, shareholder Shahid Haque ("Haque") sent his first demand to inspect Tesla's books and records pursuant to Section 220 of the Delaware General Corporation Law, 8 *Del. C.* § 220 ("Section 220"). Slip Op. at 1. Haque claimed that, through its public statements, "Tesla has repeatedly misled investors as to the Company's capacity, in order to create the false impression that the Company is selling (delivering) as much as it can produce." *Id.* at 10. He alleged that, during the third and fourth quarters of 2014 and the first quarter of 2015, Tesla had "manipulated and understated its manufacturing capacity to create the impression that the level of demand for Tesla's vehicles vastly exceeds Tesla's manufacturing capacity." *Id.* Tesla initially rejected the records demand, arguing that Haque had failed to articulate a credible basis to suspect corporate wrongdoing. *Id.* at 7. After continued discussions, however, Tesla produced 878 pages of documents. *Id.* Haque responded that the production was inadequate and, shortly thereafter, issued a second demand, citing new developments in the first and second quarters of 2016. *Id.* at 8. Although the parties engaged in further discussions, they reached an impasse in mid-2016, prompting Haque to seek an order from the Court of Chancery to compel Tesla to produce the documents demanded. *Id.*

The Court's Analysis

By stipulation of the parties, the Court decided the case on the basis of the paper record and the arguments of counsel. *Id.* at 2. The Court addressed a single question: Had Haque demonstrated a credible basis to infer possible wrongdoing that would warrant additional investigation? *Id.* at 9. The Court reiterated that, under Section 220, shareholders have the right to inspect corporations' books and records for a "proper purpose." *Id.* The Court noted, however, that this right is "broad but not unlimited." *Id.* Section 220 permits shareholders of a Delaware Corporation, in certain circumstances, to gain access to records after demonstrating, by a preponderance of the evidence, that there is a credible basis to infer mismanagement or wrongdoing by the corporation's agents. *Id.* at 2. The Court emphasized that the credible basis test strikes "an appropriate balance between encouraging productive Section 220 actions

where there is a reasonable likelihood of wrongdoing while preventing inspections without a factual basis from draining corporate resources." *Id.* at 33 (quoting *La. Mun. Empls.' Ret. Sys. v. Lennar Corp.*, 2012 WL 4760881, at *3 (Del. Ch. Oct. 5, 2012)).

In this case, the Court found that Haque's theory of Tesla's wrongdoing was far from credible—indeed it was "hard to fathom." *Id.* at 13. Haque alleged that Tesla repeatedly had fabricated production problems to explain away lower-than-expected shipment numbers, concealing slumping demand for its vehicles. *Id.* at 12. Analyzing the claim quarter-by-quarter, the Court found that there was little reason to doubt that Tesla experienced occasional production problems given its complex manufacturing process and large supply network for specialized parts. *Id.* at 4. The Court found that Haque had imagined a devious plot based on faulty logic and inconsistencies in Tesla's statements that did not exist. *Id.* at 15–16.

The Court's analysis of Haque's assertions of wrongdoing as to the third quarter of 2014 is instructive. *Id.* at 14–17. In its July 2014 Shareholder Letter, Tesla stated that in that quarter it planned to produce 9,000 vehicles and deliver 7,800. *Id.* at 14. The Letter stated that, during that quarter, Tesla planned to retool a factory, resulting in a two-week shutdown that would impact both shipping and production. *Id.* at 15. In November 2014, Tesla announced that during the third quarter, it had delivered 7,785 vehicles, consistent with its plan, but had produced only 7,200 vehicles, missing its planned target by 1,800. *Id.* at 15. Tesla explained that the planned factory-retooling shutdown had lasted two weeks longer than originally expected, resulting in the lower production number. *Id.* at 14. Haque argued that, if the factory were shut down for four weeks, both production and deliveries would, logically, "be equally negatively impacted." *Id.* at 15. The fact that Tesla met its guidance as to deliveries, but came up short on production, Haque argued, established a credible basis to infer that Tesla had either held back production or made false claims about production obstacles to conceal low demand. *Id.*

The Court rejected Haque's theory, finding it had "no support in the evidence or in basic logic." *Id.* at 16. Even before the third quarter, Tesla stated that the planned two-week shutdown would have a greater impact on production than on deliveries—an unsurprising prediction given that deliveries could include completed vehicles already in the distribution pipeline prior to the factory shutdown. *Id.* The Court found that Tesla's "straightforward, credible explanation" for how it could meet its delivery guidance in spite of a longer-than-expected factory shutdown left "no room for a credible basis to infer wrongdoing." *Id.* at 16–17. In similar fashion, the Court found Haque's theories of wrongdoing for the remaining quarters did not satisfy the "credible basis" test. "When viewed in the aggregate," the Court concluded, "Haque's evidence amounts to nothing more than 'suspicion or curiosity.'" *Id.* at 33 (quoting *City of Westland Police & Fire Ret. Sys. v. Axcelis Tech., Inc.*, 2009 WL 3086537, at *4 (Del. Ch. Sept. 28, 2009), *aff'd*, 1 A.3d 281 (Del. 2010)).

Takeaways

The *Tesla Motors* decision demonstrates the Court of Chancery's gatekeeping function in assessing Section 220 records requests premised on alleged corporate wrongdoing. While a shareholder "need not actually prove the wrongdoing itself by a preponderance of the evidence," he or she must show "a credible basis from which the Court of Chancery can infer there is possible mismanagement that would warrant further investigation." *Id.* at 11 n.44 (quoting *Sec. First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 565 (Del. 1997)). The decision gives corporate defendants a powerful tool in resisting records requests that amount to, in the Court's words, little more than "fishing expedition[s]." *Id.* at 11 n.46.